BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

In the Matter of the Application	)	
HAWAIIAN ELECTRIC COMPANY, INC.	)	Docket No. 2008-0083
For Approval of Rate Increases and	)	
Revised Rate Schedules and Rules	)	
	)	

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REPLY BRIEF OF
THE
DEPARTMENT OF DEFENSE

AND

CERTIFICATE OF SERVICE

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I. INTRODUCTION

On January 5, 2010, the Department of the Navy, on behalf of the Department of Defense ("DOD"), filed its Opening Briefs, which addressed the issue of return on equity. Therefore, the purpose of this Reply Brief is to discuss those key points that support the DOD's recommended return on equity.

II. HECO ERRS IN ITS CLAIM, AT PAGE 176 OF ITS OPENING BRIEF THAT THE FAIR AND REASONABLE COST OF COMMON EQUITY FOR HECO IS AT LEAST 10.75%.

Such statement is based on the updated testimony of its cost of capital witness Dr. Roger Morin. However, DOD illustrated in its Opening Brief that Dr. Morin has changed his equity cost estimation methodologies for reasons that are neither logical nor theoretically sound, therefore, in doing so, has produced a cost of capital result that substantially overstates both the cost of equity capital and the cost of equity estimate that his original analyses would have indicated.

Prior to his Rebuttal Testimony in this proceeding, Dr. Morin had, for many years relied on a historical risk premium analysis for electric utilities based on the historical earned returns of Moody's Electric Utility Index and U.S. Treasury bonds. In both his Rebuttal and his Update, Dr. Morin changes both the index and the interest rate measure and produces substantially higher results. Similarly, in his Rebuttal and Update, Dr. Morin simply omits another long-used methodology—the "Allowed Return" risk premium. Had he not done so, that methodology would have produced an equity cost estimate well below 10%.

As noted in the Opening Brief of DOD, Dr. Morin has not provided rational explanations for the changes to his methodology. For example, Dr. Morin cites financial turmoil as rationale for changing his historical electric utility risk premium, however, those dire conditions do not exist now , thus, could not provide rationale for a dramatic change in methodology. Besides, it is simply illogical to continue to rely on T-Bonds in one cost of capital estimation method (CAPM, ECAPM) and reject that measure as unreliable in another. Similarly it is illogical to claim that the discontinuance of the publication of an electric utility index in 2002 was fine in 2008 but problematic in 2009. Also, as DOD pointed out in the evidentiary hearing (Tr. 1023, ll. 11-15) and in Brief, the rationale supporting Dr. Morin's decision to omit his Allowed Return risk premium is not factually correct.

If Dr. Morin's cost of equity methodologies had been consistently applied in this proceeding, and not altered to produce higher results, as shown in DOD's Opening Brief, the average of Dr. Morin's updated equity cost estimates would have been 10.06%, without a flotation cost adder. Therefore, if the Commission is to consider the Company's equity return recommendation in this proceeding, it should rely on the same methods that the Company originally presented, therefore, in doing so, determine that the fair and reasonable cost of common equity for HECO is at least 10.06%, not the 10.75% claimed in HECO's Opening Brief.

III. FLOTATION COST IS UNNECESSARY.

As discussed in detail in DOD T-2, at pages 45 through 47, there are many reasons why an explicit flotation cost adjustment is unnecessary. Flotation costs are not out-of-pocket costs paid by the Company. Those costs are, effectively, commissions received by the investment bankers or underwriters that facilitate initial equity offerings. Those fees, or discounts, are known by the investors that purchase the stock and are accounted for in the stock price. The investors (who are also investment bankers) know that some small percentage of the money provided for the newly-issued common equity will go to the underwriter, not the company issuing the stock. Therefore, if that stock price did not comport with the investors' risk/return requirements for that type of investment, the investment would not be made. The investors who purchase stock in the secondary market (e.g., NYSE, NASDAQ) also pay broker fees or commissions that raise the effective price, but cost of equity analysts do not adjust stock prices to account for those commissions, and should not do so for fees incurred in the original offering market.

As DOD noted in Mr. Hill's testimony, raising the cost of equity allowed in this proceeding by the 30 basis points requested by HECO for flotation costs, would raise rates to HECO's ratepayers by $3.4 Million annually. Even assuming, contrary to fact, that flotation costs were out-of-pocket costs for the utility, HECO's parent would have to issue almost $70 Million of common equity annually and contribute that amount to HECO in order to generate that purported level of "cost." As DOD-T2 notes at page 47, the Company's financial forecasts do not support such a scenario. Therefore, including a 30 basis point allowance in the allowed return would require HECO ratepayers to reimburse the company for costs that it will not incur. Therefore, including a 30 basis point adder to the allowed return on equity in what even the Company recognizes to be difficult economic times seems especially pernicious.

IV. ALLOWED RETURNS MAY NOT BE A RELIABLE INDICATOR OF CURRENT EQUITY CAPITAL COSTS.

At pages 178 and 179 of its Opening Brief, HECO cites average allowed returns for other electric companies and implores the Commission not to allow the Company a return below those average levels. However, as indicated in the evidentiary hearing (Tr. 1028-1037; DOD Exhibit 3) there are aspects of the reported allowed returns that indicate they may not be a reliable indicator of current equity capital costs. Even assuming that allowed returns of other companies in other regulatory jurisdictions with other regulatory frameworks were reliable indicators of the current cost of common equity; as shown on DOD Exhibit 3 (RRA's October 2, 2009 Report, p.3) through the third quarter of 2009, the average electric utility allowed equity return was 10.43% (lower than the prior year) and, more importantly, that return was allowed on a regulatory capital structure consisting of about 48% common equity. HECO's rates will be set with a much higher common equity ratio, imparting less financial risk than the other electrics utilities, therefore, indicating a much lower allowed return on equity is appropriate for HECO.

The most important piece of "relative return" information overlooked in the Company's Opening Brief is the equity return HECO expects to earn on its own investments. HECO and its parent, HEI, have pension fund investment portfolio. Those investments are comprised of both common equity investments and fixed-income or debt investments. The Company and its parent have about $700 Million in equity investments in their retirement portfolio. (DOD T-2, p. 51) The return HECO expects to earn on its own common equity investments over the long-term is *below* the 9.25% low end of DOD witness Hill's range of equity cost estimates. (DOD-IR-11) If the Commission is considering the returns allowed other utilities by other commissions it should also consider, in balance, the return on equity HECO expects to earn on its own equity investments. The cost of capital is defined as the return investors expect to earn, and HECO's pension fund equity return expectation is a direct measure of the cost of equity capital.

V. CAPITAL ASSET PRICING MODEL SHOULD NOT BE IGNORED.

At page 191 of HECO's Opening Brief, the Company states most emphatically: "The CAPM is a fundamental paradigm of finance." Yet, three pages later the Company implores the Commission to provide "little, if any, weight" to its CAPM results. The Company then attempts to provide three reasons to ignore a fundamental paradigm of finance in determining the return to allow in this proceeding. None of those reasons hold up under scrutiny:

- "CAPM estimates are barely above the corporate cost of debt"- Dr. Morin's CAPM estimates range from 9.4% to 9.8% in his update, and in the evidentiary hearing he indicated the current cost of utility debt was 6.2% (Tr. 1019). The cost rate difference between Dr. Morin's updated CAPM results and the cost of utility debt is 320 to 360 basis points—considerably more than "barely above."
- "The impact of the financial crisis is not fully captured in betas" - As noted in HECO's Opening Brief, between the filing of Dr. Morin's direct and rebuttal testimonies the average beta of his sample group fell from 0.85 to 0.75. The latter figure (0.75) includes the relative stock price

changes that occurred during the financial crisis and indicates that utilities were far less risky than the stock market in general. That is, if the addition of approximately one year of data in the beta calculation cause the five-year average to decline more than 10%, then during that additional year (the "crisis" period) utilities were substantially less risky than before and that reduction in risk is captured in the current beta. If it were "fully captured" as the Company would like, undoubtedly the average beta (and the resulting CAPM equity cost estimate) would be even lower.

- "Government interest rates have decreased substantially....thus lowering CAPM results" - This is simply evidence that the Company does not want to acknowledge that capital costs are low. The CAPM is a paradigm of finance and government bonds are the risk-free rate called for in that model. If government bond yields are low, then the CAPM provides an indication of low capital costs (and vice versa). However, the Company is simply incorrect that government bond yields are "low." The T-Bond yield used by Dr. Morin in his Direct was 4.6%, and during the hearing he noted it was 4.3% (Tr. 1017).

VI. HECO'S DISCOUNTED CASH FLOW ANALYSIS RESULTS ARE OVERSTATED.

At pages 199 and 200 of is Opening Brief; HECO discusses the DCF growth rate analysis offered by its cost of capital witness, Dr. Morin. Dr. Morin's sole reliance on sell-side analysts' projected earnings growth rates severs to overstate the cost of capital estimate, as described in detail in DOD T-2, pp. 27-29. In relying exclusively on one type of growth rate for his DCF analysis, Dr. Morin has ignored academic research which shows that the sell-side analysts over-estimate the growth rates of the stocks they follow. Moreover, the theory on which the DCF is built holds that, over the long term, utility dividends, earnings and book value will grow at the same rate; however, Dr. Morin fails to analyze any other indicators of long-term growth for utilities.

At pages 64 and 65 of DOD T-2, Mr. Hill points out that the average DCF growth rate of 7.2% used by Dr. Morin in his Direct Testimony is not a reasonable estimate for long-term utility growth. As shown in Mr. Hill's DOD-205 the actual average growth rate for dividends, earnings and book value pre share for utilities from 1947 through 1999 ranged from 3.2% to 3.6%, while the GDP growth during that time was 6.94%. Mr. Hill also points out that the current GDP growth rate expectation in the U.S. is about 4.5%. Given the long-term historical experience with utility growth, it is not reasonable to believe that the long-term growth currently expected by investors would be above 4.5% (the GDP projection), which is much less than Dr. Morin's unrealistic 7.2% growth rate. HECO's DCF results must be considered to be overstated.

VII. HECO'S INVESTMENT RISK IS LOWER THAN OTHER UTILITIES.

Beginning at page 208 of its Opening Brief, HECO devotes nearly twenty pages discussing details of is normal (i.e., pre-HCEI) operations in the context of business and financial risk, in what appears to be an attempt to bolster is position that it is a riskier entity than other electric utilities. However, the parties in this proceeding have accounted for HECO's risks in their cost of equity estimates. As a fundamental part of their analyses, all of the cost of capital witnesses in this proceeding, have made an effort to select a group of sample companies that have similar risk to HECO. By using bond ratings, generation mix, size, electric revenues as a percent of total, betas, purchased power as a percent of total revenues and other factors the analysts selected firms that were generally similar in risk to HECO. For example, as HECO's witness notes in response to DOD-IR-31(b), "the financial risk due to the presence of off-balance sheet liabilities such as purchased power contracts is already reflected in traditional measures of risk for HEI and for Dr. Morin's comparable-risk companies, such as beta and bond rating." Therefore, the Company's implied level of complex risks through a detailed description of the Company's pre-HCEI operations and financial position has been accounted for in the cost of equity analyses and is, therefore, not an exogenous variable that the Commission should consider as an addendum to its decision for an appropriate allowed return.

Of course, as all parties agree, should the Commission adopt the operating changes envisioned in the HCEI, the Company's overall investment risk will be reduced compared to other electric utilities. As discussed at length in DOD's Opening Brief, that range of equity return decrement to recognize the reduced risks attendant to HCEO is 25 to 50 basis points.

Regarding the risk reducing impact of the HCEI initiatives, HECO states at page 234 (and page 246) of its Opening Brief that the market-derived cost of common equity for other firms already incorporates the results of similar HCEI mechanisms. DOD notes that there is no cite to the record to support this statement. Besides, while there are cost-recovery mechanisms scattered about the electric utility industry (a decoupling model here, a fuel adjustment clause there, the ability to rapidly recover plant investment in another place), DOD witness Hill noted in DOD T-2 (pp. 6-8) that, because of the combination of several make-whole rate mechanisms in HCEI, HECO's regulatory environment will be substantially different and less risky . Moreover, the multi-factor aspect of HCEI makes it significantly different (and more risk-reducing) than any individual regulatory adjustment clause. Therefore, it is most unlikely that the risk-reducing aspect of something as fundamentally different as HCEI is captured in the market data of other, otherwise similar-risk electric utilities.

VIII. DECOUPLING REDUCES THE RATE OF RETURN.

At page 252 of the Company's Opening Brief, HECO states that a 50 basis point ROE decrement "seems too significant a downward move for a policy that is strongly supported by many environmentalists and elected and appointed policymakers." Surely, the Company does not believe that the appropriate impact on the rate of return on a utility investment caused by a change in regulatory policy has any relationship whatsoever to who or what is in favor of that policy. The appropriate change in the rate of return is impacted by only one thing—the change in the level of risk. If the risk is reduced, the return should also be reduced. It is very clear that a decoupling regime which would liberate HECO from its dependence on the wide swings in the economic environment in Hawaii caused by the volatile tourism industry, would lower the Company's risk. If HECO's kWh sales are down due to low occupancy in Oahu's hotels, the Company's revenues will not be affected as they are now. Its risk will therefore be reduced. As DOD witness Hill noted at page 8 of DOD T-2:

"With reduced risk, the rate of return allowed the Company should also be lower than it would have been absent HCEI. This should not be construed as any sort of negative aspect of a truly innovative approach to future energy supply and use, but rather a rational assessment of risk and return. An income stream that is less volatile is less risky and should be afforded a lower return—it is just that simple."

IX. HECO FOCUSES ON THE CREDIT RATING OF HEI INSTEAD OF HECO.

In Section F. of its Opening Brief, beginning on page 255, HECO discusses the importance of credit ratings. The Company notes at the outset that S&P rates the Company's corporate (general) credit rating at "BBB" while Moody's Investor Service rates HECO's corporate credit rating as Baa1, a notch higher. In its discussion of credit ratings, the Company focuses on the lower rating published by Standard & Poor's.

However, the Company fails to inform the Commission that Moody's rating (the higher corporate credit rating) focuses only on HECO, its operations and regulatory support. The parent company's operations and its banking subsidiary operations are not considered in Moody's determination of HECO's credit rating. Also, as evidenced by Standard & Poor's May 27, 2009 report on HECO (CA-RIR-34, Attachment 1, p. 12) that rating agency's credit ratings for HECO are based on the consolidated credit risk of the parent company, HEI, which includes debt issued by HEI as well as the operations of American Savings Bank (ASB). The S&P credit report considers the "consolidated financial metrics" in determining HECO's credit rating.

The Company's focus on the lower credit ratings reported by S&P, then, does not reflect HECO operations alone, but in consolidation with its parent company, HEI. To the extent that the parent company operations carry more risk, the bond rating reported by S&P for HECO will reflect those added risks. Those additional consolidated risks are not risks that HECO's ratepayers should be required to shoulder. Therefore, a more appropriate focus for the Commission in determining the financial health of HECO is Moody's higher Baa1 (equivalent to S&P's "BBB+") rating, which is average risk for electric utilities in the U.S.

Finally on the subject of credit ratings, HECO discusses the importance of regulatory support. CA-IR-42, Attachment 1 contains a November 25, 2008 report by Standard & Poor's that reviews regulatory agencies and rates them in relation to their supportive nature. S&P rates regulatory commissions into four categories ranging from "least credit supportive" to "more credit supportive." The Hawaii Commission is classified as "credit supportive," with only 8 regulatory commissions having higher credit support.

X. SUMMARY

As noted in the DOD's Opening Brief, the range of reliable equity returns from which this Commission can reasonably choose an allowed return for HECO varies from 9.25% (the lower end of DOD witness Hill's range) to 10.50% (the upper end of CA witness Parcells' range). If the Commission intends to approve any part of the HCEI, the allowed return on equity should be lowered.

As DOD T-2 indicated at page 50, the Commission could allow the Company to recover a 9.5% return on equity and provide the opportunity for HECO to achieve a pre-tax interest coverage that exceed its historical interest coverage levels, thereby maintaining the company's financial position. Therefore, within the equity return range cited, the Commission has the ability to 1) recognize any risk-reducing aspects of the HCEI it wishes to approve and 2) provide ratepayers the much needed respite in these difficult economic times, while 3) maintaining the Company's financial position and continuing to provide "credit supportive" regulation.

CERTIFICATE OF SERVICE

I hereby certify that one copy of the foregoing document was duly served upon the following parties, by U.S. mail, postage prepaid, and properly addressed pursuant to HAR sec. 6-61-21(d).

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